

# The Customer as King-Maker

When cash is king, CFOs evaluate the pros and cons of cash-generating strategies.

**Small companies in the United States will continue to feel the impact of the recession for the next several years.** Those that have been strong enough or lucky enough to make it through the economic downturn are unlikely to find comfort in the prospect of a slow and uncertain economic recovery. Our recent research among senior finance executives at companies with less than \$100 million in annual revenue reveals that small enterprises have endured the recession by controlling costs aggressively and by redoubling their focus on customers. Nonetheless, many finance executives foresee a long road back to strong economic footing. In the free-text responses of a recent survey conducted by CFO Research Services, the CFO of a small U.S. company observed, “We lost 12 years’ worth of revenue growth in one year, and it will take several years to earn that back.” (To read the full results of this study, download *Getting Focused, Getting Ahead: Finance Executives on Managing Leaner Organizations Equipped for Growth* from [www.cfo.com/gfga](http://www.cfo.com/gfga).)

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Although smaller companies are facing the same kinds of challenges as their larger competitors, they typically have fewer tools at their disposal to distribute risk and generate cash. Many smaller companies are underfinanced, and it has become harder for them to find investors willing to put capital at risk to fund day-to-day operations and long-term growth. These companies are also coming up against the hard reality of banks’ continued reluctance to lend on attractive terms, despite government and public pressure to do so.

Smaller companies often struggle to find external sources of the cash they need to cushion them from market volatility, fund day-to-day operations, and spur growth. Accordingly, they rely on current business operations to provide near-term liquidity and long-term investment capital. The CFO cited in the study above stressed in his comments, “We need more operating cash reserves to weather financial fluctuations.” And a CFO in the health-care industry advised, “If the company effectively manages its cash flow, it should be able to navigate the tight credit markets in the short term, which

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should lead to a stronger company in the long term.” Another CFO, from the wholesale/retail industry, observed, “The companies that survived the current economic downturn are the ones that were able to react quickly and control their cash flow. Profit and loss were somewhat irrelevant as long as cash flow and liquidity were stable.”

But if cash is king these days, customers are the king-makers—and smaller companies may have difficulty stabilizing their cash flows and liquidity with their current customer base. These companies are more likely than larger firms to be dependent on a few strong and established customer relationships. Eager for revenue, smaller companies are often at a disadvantage when negotiating payment terms. Frequently, their customers are looking to lengthen payment terms at exactly the time that suppliers are looking to shorten them. In fact, in a current CFO Research survey on cash-management techniques, preliminary responses show that European finance executives from larger companies—that is, the type of company that smaller suppliers are more dependent on—say that one of their top priorities for the coming year is to negotiate more-favorable terms with their suppliers. (The results of this study will be published in August 2010 under the title, *Working Capital Management in a Post-Recession Environment: The View from Europe*.)

Looking ahead to his company’s own growth prospects, a CFO from the earlier study noted that “we need to not be overly reliant on one or two large customers; we need to diversify revenue sources.” But diversity can be a double-edged sword. On the one hand, with more customers, cash flow is boosted and collections risk is spread. On the other hand, having more customers introduces more complexity in accounts receivable and requires more resources to manage the collections process—demands that may put a strain on smaller companies’ finance organizations. In addition, no small company wants to put customer relationships at risk with an overly strident approach to accounts receivable.

In these circumstances, smaller companies find themselves more interested in exploring a range of strategies for managing their cash flows. These include the following:

- **Bank financing:** For smaller companies, the credit freeze was especially insidious. As a CFO commented in our previous survey, “The company was hit hard very quickly [during the recession], and the bank added to the pain much more than was necessary.” This strain appears to be continuing in the wake of the recession, as banks tighten risk controls and covenant terms. Smaller companies are still finding it hard to arrange short-term financing at favorable terms and rates.
- **Commercial paper:** As with bank financing, this is another avenue not as readily available to smaller companies. Only firms with excellent credit ratings from a recognized rating agency are able to sell their commercial paper at a reasonable price. In addition, the proceeds from this type of financing can be used only on current assets without complicating the transaction with SEC involvement; they are not allowed to be used on fixed assets, such as new production facilities.
- **Online receivables auctions:** New technology and low returns from conventional short-term investments have opened up new private markets that match investors seeking short-term returns on cash with companies that want to sell some or all of their high-quality receivables. The receivables sell at a discount, the private market receives a fee, and the investor earns a return on short-term cash investments. Sellers receive cash quickly without affecting their relationships with customers.
- **Factoring:** Factoring involves bundling all of a company’s receivables and selling them at a discount as a financial asset to a bank or other third party to generate instant cash. The seller of the receivables doesn’t have to wait for payment, while the buyer assumes responsibility for collections and for its own profit down the road. However, by introducing a third party, this strategy poses the danger of compromising customer relationships at a time when every customer and every new order is precious.
- **Float from credit cards:** This cash strategy is commonplace, especially among the smallest companies. However, while credit-card float may be attractive to smaller companies as a way of freeing up cash in certain types of transactions, it’s hard to consider it a primary financing strategy for long-term business growth.

- **Supply-chain financing:** The economic downturn spurred additional interest in this evolving strategy, as larger buyers became more concerned with ensuring the viability of their critical supply-chain partners. The strategy involves providing smaller suppliers access to the more favorable credit terms enjoyed by a larger or more established partner company. However, if a supplier plans to diversify its customer base, supply-chain financing has the potential to tie a company more tightly to a single, large buyer.

**A more diverse customer base can be a double-edged sword. Having more customers boosts cash flow and spreads collections risk. But it also introduces complexity in accounts receivable, which may strain smaller companies’ finance organizations.**

Each of these strategies has its benefits, and each has its drawbacks. No single strategy is likely to meet all the financing needs of smaller companies as they look to resume growth paths. Executive management, and finance executives in particular, must fully understand the financing options available to them, and then stock their financial toolbox with the strategies that are most likely to optimize their collections process without compromising their crucial customer relationships.

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